



August 4, 2003

Ms. Leezie Kim, Executive Director
Citizens Finance Review Commission
Office of the Governor
1700 W Washington
Phoenix, AZ 85007

Dear Ms. Kim:

Arizona Lottery: Three Issues Impacting Revenue Growth

Background

The Arizona State Lottery was created by statute in 1981 as a funding mechanism for various beneficiary programs, as designated by the legislature, or as mandated by referendum. Since its inception, the Arizona Lottery has generated almost \$1.6 billion to support statewide projects and programs. Prizes for our players have totaled over \$2.4 billion, and we have paid our retailers more than \$255 million in commissions.

The basic financial model of the lottery (based on the Lottery's FY 2003 income statement) can be described as follows:

• Player Prizes	54.96%	(of revenues)
• Funding State Programs	28.68%	
• Operations	9.70%	
• Retailer Commissions	6.67%	

By statute, player prizes cannot be less than 50% of revenues. Advertising cannot be more than 4% of revenues (currently appropriated at 2.7%). Operating expenses and retailer commissions cannot be more than 18.5% of revenues, and are currently running at 16.2%.

In fiscal year 2003, Lottery revenues were \$322 million and distributions to beneficiary programs were \$95.7 million including a \$3,263.1 million distribution to the Court Appointed Special Advocate Program (CASA). This distribution comes from the Unclaimed Prize Fund, not revenue.

Can Amounts Available for Beneficiary Distribution be Increased?

The underlying business model that drives revenue growth for the Lottery must be understood in order to evaluate options for increasing amounts available for distribution to beneficiary programs. The three factors that affect the long-term health and viability of the Arizona State Lottery as an effective means of generating revenues for the state are product mix, retail distribution and prize payout. An overview of Arizona's performance in comparison to other state lotteries provides a useful context for discussion. See Attachment A.

Arizona had per capita lottery sales of \$54 in 2002. Of 39 states reporting for FY 2002, only two states, Nebraska and Montana, had lower per capita sales of lottery tickets. Based on total sales, Arizona ranked 29th out of 39 states. During the past decade, the population of our state has risen dramatically and lottery sales have remained relatively stable. This would indicate a decline in real sales, as total revenues are not rising as quickly as population growth.

When comparing Arizona's state sales with those of other states it is important to note that our product mix and distribution is relatively limited. Another factor is the degree of legislative and/or public support for the lottery as a method of funding programs.

States such as Texas, Georgia, Maryland, and Rhode Island are powerful examples of what the impact population, public support or product mix can have on sales. However, states such as Colorado, Missouri or Indiana may be more similar to Arizona in demographics and legislative climate.

Texas revenues of \$2.9 billion, or Georgia revenues of \$2.3 billion are impressive examples of what larger states have done with popular support of their lotteries and a focus on beneficiaries (i.e. education in this example) as part of their advertising. Per capita, these states are at \$126 and \$261 respectively.

Maryland is a state with the same population as Arizona, 5.5 million. However, their total revenues of \$1.3 billion include \$355 million from Keno games which are not part of the product mix in our state. Tiny **Rhode Island**, with a population of 1.1 million generates lottery revenues of \$1.1 billion, but that includes \$935 million from VLT's (video lottery terminals) which are not currently allowed in Arizona.

Colorado has a population of 4.5 million, total sales of \$407 million, including instant ticket (also called ScratchersSM) sales of \$257 million. **Missouri** has a population of 5.7 million, total sales of \$585 million including instant ticket sales of \$316 million. **Indiana** has a population of 6.2 million, total sales of \$626 million including instant ticket sales of \$352 million. By comparison, for FY 2002, Arizona had a population of 5.5 million, total sales of \$294 million including instant tickets sales of \$143 million.

A conclusion might be drawn that without introducing a new product such as Keno or Video Lottery Terminals, our state could focus on increasing the sales of a product currently in our mix – instant Scratchier tickets – to the level experienced in states of similar size. Using the states of Colorado, Missouri and Indiana as examples we find that their per capita weekly sales of instant tickets (only) is \$1.08, \$1.22, and \$1.17 respectively, or about one ticket a week per capita.

What are the issues impacting our ability to increase *instant ticket sales* in Arizona?

Three factors are affecting our ability to increase instant ticket sales – product mix, prize payout and distribution.

The first two are related. Market research tells us that citizens purchase lottery tickets for their entertainment value and for the opportunity to win cash prizes. Together, these factors create the “customer experience.” If the play value on a ticket is not perceived as “fun” and “entertaining,” or if the incidence of winning some kind of prize is not perceived as “often enough” than the customer will cease to purchase. Therefore, the lottery industry is constantly challenged to introduce new and different styles of play and to return prizes on a regular basis. What began as a limited series of \$1 dollar tickets twenty years ago is now a full array of 16-20 different tickets in the market at any one time in Arizona, and at price points of \$1, \$2, \$3, \$5 and \$10.

We can successfully meet the challenge of providing entertainment value and advertising our product effectively. The serious challenge of offering enough winning experiences to keep people buying remains.

What is the impact of prize payout on lottery revenue growth?

(Note: Much of the information that follows is based on the “Impact of Increasing Instant Product Prize Payout” study released by Scientific Games International, September 2002.)

In the 39 states currently selling instant tickets similar to the Arizona Lottery’s Scratchers product, the average percent of revenue returned to players (*the prize payout*) is approximately 65%. The highest prize payout, 72%, is in Massachusetts. This state of 6.4 million people had total lottery revenues of \$4.1 billion in 2002, and instant ticket sales of \$2.9 billion.

In Arizona, the average instant ticket payout is 60%, well below the national average. Certain of our most popular \$2 and \$3 games have a payout of 65%, which accounts for their steady sales and reliable source of revenue. This is made possible because other tickets (primarily at the \$1 price point) have a lower payout, approximately 55%, so that our combined average remains near 60%.

(This discussion related to instant tickets, only. When combined with our lotto-style games and Powerball®, the average prize payout on total sales in FY 2003 was 54.96% noted on page one.)

Previously we noted that sales have not kept pace with population growth. Citizens that are new to our state or current residents who have just never chosen to purchase an instant ticket, may choose to do so if our advertising efforts are effective.

Most first time participants will buy the most inexpensive, or “entry level” ticket for \$1. Unfortunately, it is these lower priced tickets that have the lowest prize payout. Therefore, the opportunity to create a favorable customer experience – winning – is lower. If after several attempts, the customer does not win, they stop playing.

Conversely, players who purchase a \$3, \$5, or \$10 ticket expect a “bigger” return on their investment. In this price range, a winning experience is not enough to maintain a player’s interest. The experience must include a meaningful prize.

It then becomes more and more difficult, even with an effective advertising campaign, to continue to introduce new customers to the instant ticket product line. Without growth in customer purchases, revenues stagnate or decline.

If the objective is to increase the monies available for program funding, than the percentage of revenue used in player prizes needs to increase to the national average of 65%. This would address one of the key issues currently inhibiting growth of the instant ticket product sales.

However, if the overall prize payout on instant tickets is increased to 65%, and the payout on lotto games remains constant, the percentage available for funding programs will be reduced. Therefore, this change must result in increased sales so that current and future beneficiaries will see growth in real dollars available, even though these dollars may be a smaller percent of a larger pie.

The strategy has been implemented successfully in California, Colorado, Connecticut, Idaho, Kentucky, New Mexico, New York, Ohio and Washington. However, in most cases, it took a significant amount of time for new games introduced at the higher prize payout to “catch on” and make an impact on sales. It took from 8-18 months to see the full impact on sales, so caution is warranted in projecting any immediate increase in revenues.

To increase the prize payout to an average of 65% across the instant ticket product line will require a statutory change, as well as an education process for current beneficiaries as what to expect and when. For a list of current beneficiaries and an example of the complexities of the current distribution methods, see Attachment B: FY 2003 Arizona Lottery Fund Distributions to State Programs.

What impact does effective distribution have on instant ticket sales?

With an appropriate mix of product play styles and price points available in the instant ticket line and an effective advertising campaign, customers will purchase tickets. With an increased payout percentage, they will have a positive customer experience and continue to play. However, this can only happen if the tickets are easily accessible for them to purchase.

The Arizona Lottery works with a network of over 2,600 independent, small and large businesses to sell its tickets. This retail network consists predominantly of grocery and convenience stores such as Fry's, Basha's, Circle K and 7-Eleven. Common practice in the industry is to display and sell instant tickets in grocery stores in an "ITVM" –an Instant Ticket Vending Machine. This avoids the problems of holding up a line of shoppers while customers consider what ticket to purchase and allows customers to consider 10 different ticket options and price points at their leisure.

Across the nation the average number of ITVMs with placement as a percent of the total retailer network is 17.75%. The percentage in Arizona is only 12.6%. While some states, such as Minnesota, have very few ITVMs, many of the most successful states have these machines at 20-30% of their retail network. The ability to purchase the product easily is a key component of sales growth. As a ratio of the number of ITVMs to the number of residents (population), in Arizona the ratio is 1:16,998. Only 5 other states, out of the 39 lotteries, have a ratio this high or higher.

The total number of ITVMs currently in Arizona is 321. Only nine states have fewer ITVMs than Arizona. Increasing the number of ITVMs would be a more effective and efficient means of distributing our instant tickets and would lead to increased sales. This was, in fact, the recommendation of the Auditor General's Office in their most recent review of the agency, conducted in 2002.

However, the current number of ITVMs allowable is limited by a special line item appropriation to 321. **A reasonable increase to approximate the national average of 17.5%, or to approach the 20% (at the low end) seen in the more successful states, would result in about 500 machines in Arizona and would support an increase in sales.**

What other issues should be considered in increasing net proceeds to beneficiary programs?

As was mentioned earlier in the overview of the national results, product mix and beneficiary selection have a significant impact on revenue.

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In states, such as West Virginia and Pennsylvania, the connection between lottery play and the benefit to the state's seniors in reducing the cost of care and prescription medication has been very successful. In Georgia, the direct link between lottery play and the funding of college educations, the "Hope Scholars" program, has made possible an impactful and enduring public relations and advertising campaign. In Arizona, the myriad of beneficiary programs and the complex method of distributing funds have made widespread understanding of the positive impact more difficult.

Product mix is another facet to consider. The introduction of new elements, such as Keno or Video Lottery Terminals, or pull-tab products, have been highly successful in some states and constitute a majority of their revenue. However, this may not be politically feasible in a conservative state such as Arizona, and in light of our gaming compacts with the various Indian tribes, may not even be possible. For this reason, rather than explore the addition of new products, our discussion has focused on improving the sales of one of our existing product lines, instant tickets. If desired, additional information on these alternative lottery products can be provided.

What amount of increase in monies available for program funding could result if these issues are resolved?

It is important to note that the increase in revenues resulting from an adjustment of the prize payout percentage for instant tickets from 60% to 65%, and the addition of ITVM machines to a number between 17.5% and 20% of total retail locations, cannot be guaranteed. However, a reasonable goal would be to attain a weekly per capita sales of instant tickets similar to that experienced in the comparable state lotteries of Colorado, Indiana or Missouri – roughly a \$1 per week per resident, an increase over our current weekly per capita of 52 cents.

If this sales increase was achieved after the first 18 months, instant tickets sales might reach \$250-300 million annually. This would be an increase of almost \$100 million, over 2002 sales. **This translates to an increase of approximately \$25 million dollars available for funding current or future beneficiary programs.**

Sincerely,



Kathleen S. Pushor
Executive Director

Enclosures